

# **NAVAL POSTGRADUATE SCHOOL**

## **Monterey, California**



## **THESIS**

### **TRANSACTION COST ECONOMICS AND A-76: A FRAMEWORK FOR DEFENSE MANAGERS**

by

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June 2002

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**TRANSACTION COST ECONOMICS AND A-76: A FRAMEWORK FOR  
DEFENSE MANAGERS**

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## **ABSTRACT**

With competing demands on DOD's limited budget, outsourcing, within the OMB Circular A-76 framework, has been the vehicle of choice to attempt to achieve cost savings. However, the bureaucratic process is not always compatible with realization of long-term savings. While corporate America has experienced real savings through outsourcing, DOD's experience has not been as successful.

This thesis offers a new framework for analyzing DOD outsourcing using the principles of Transaction Cost Economics (TCE). The key tenets of TCE (asset specificity, complexity and frequency) are defined and their usefulness demonstrated as evaluation criteria in the outsourcing process. Additionally, the concept of opportunistic behavior in outsourcing arrangements will be analyzed. By using these concepts, within the A-76 process, stakeholders would have a method that could help avoid bad outsourcing decisions and achieve significant cost savings on a more consistent basis through more appropriate contract types.

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## TABLE OF CONTENTS

<b>I.</b>	<b>INTRODUCTION.....</b>	<b>1</b>
<b>A.</b>	<b>BACKGROUND .....</b>	<b>1</b>
<b>B.</b>	<b>OBJECTIVE .....</b>	<b>1</b>
<b>C.</b>	<b>BENEFITS OF THIS STUDY .....</b>	<b>2</b>
<b>D.</b>	<b>SCOPE AND METHODOLOGY .....</b>	<b>2</b>
<b>E.</b>	<b>ORGANIZATION OF STUDY .....</b>	<b>3</b>
<b>II.</b>	<b>TRANSACTION COSTS ECONOMICS (TCE) FOR DEFENSE ACQUISITION MANAGERS.....</b>	<b>5</b>
<b>A.</b>	<b>THE “MAKE OR BUY” DECISION-THE POTENTIAL FOR OUTSOURCING .....</b>	<b>6</b>
<b>B.</b>	<b>OUTSOURCING PROBLEMS.....</b>	<b>8</b>
1.	<b>Opportunistic Behavior .....</b>	<b>8</b>
2.	<b>Asset Specificity.....</b>	<b>9</b>
<b>C.</b>	<b>CONTRACTING .....</b>	<b>10</b>
1.	<b>What are Contracts Supposed to Do? .....</b>	<b>10</b>
2.	<b>Variables that Impact Effective Contracting .....</b>	<b>11</b>
<b>D.</b>	<b>TCE: AN EXAMPLE .....</b>	<b>12</b>
<b>E.</b>	<b>SUMMARY .....</b>	<b>15</b>
<b>III.</b>	<b>A-76 AND TCE: UNDERSTANDING THE RELATIONSHIP.....</b>	<b>17</b>
<b>A.</b>	<b>THE PURPOSE OF A-76 CIRCULAR.....</b>	<b>17</b>
<b>B.</b>	<b>THE A-76 PROCESS .....</b>	<b>18</b>
1.	<b>Packaging.....</b>	<b>18</b>
2.	<b>Public Announcement.....</b>	<b>19</b>
3.	<b>Formulation of Performance Work Statement (PWS) &amp; Quality Assurance Surveillance Plan (QASP).....</b>	<b>20</b>
4.	<b>Solicitation .....</b>	<b>21</b>
5.	<b>Government Management Plan.....</b>	<b>21</b>
6.	<b>Independent Review.....</b>	<b>22</b>
7.	<b>Negotiation &amp; Selection of Commercial Firm to Compete with the MEO.....</b>	<b>23</b>
8.	<b>Cost Comparison.....</b>	<b>23</b>
9.	<b>Administrative Appeals Process .....</b>	<b>24</b>
10.	<b>MEO or Contractor Implementation.....</b>	<b>24</b>
11.	<b>Post-A-76 Actions.....</b>	<b>25</b>
<b>C.</b>	<b>OUTSOURCING &amp; A-76 CHALLENGES.....</b>	<b>25</b>
1.	<b>Perceived Government Advantage.....</b>	<b>25</b>
2.	<b>Overstated Cost Savings.....</b>	<b>26</b>
<b>D.</b>	<b>TCE ISSUES IN THE OUTSOURCING PROCESS.....</b>	<b>27</b>
<b>IV.</b>	<b>APPLYING A TCE FRAMEWORK TO THE A-76 &amp; OUTSOURCING PROCESS.....</b>	<b>29</b>

A.	ASSET SPECIFICITY .....	29
B.	COMPLEXITY .....	32
C.	FREQUENCY .....	34
D.	INTEGRATION.....	36
V.	CONCLUSIONS .....	39
A.	RECOMMENDATIONS.....	39
1.	Evaluate A-76 Studies and Outsourcing Actions Using the TCE Factors of Asset Specificity, Complexity and Frequency .....	39
2.	Provide Training on Transaction Cost Economics to A-76 Participants.....	39
3.	Provide a DOD A-76/Outsourcing Case Study Database.....	40
B.	AREAS FOR FURTHER RESEARCH.....	41
1.	Study a Single or a Group of Similar A-76 Competitions Using TCE .....	42
2.	Evaluate the Feasibility of Establishing a DOD or Service Specific Outsourcing Database .....	42
C.	CONCLUSION .....	42
	LIST OF REFERENCES .....	43
	INITIAL DISTRIBUTION LIST .....	47

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## **I. INTRODUCTION**

### **A. BACKGROUND**

In 1983, the Office of Management and Budget (OMB) updated Circular No. A-76 to set procedures to determine when commercial activities performed by the government can instead be performed under contract for the Government by private companies. The premise behind this policy is that “the Government should not compete with its citizens”. Simply put, the Government should not retain or perform a function or activity that can be procured more economically from a commercial source unless it is “inherently governmental.”

With competing demands on DOD’s budget, outsourcing has been touted as a method to achieve cost savings. When outsourcing is being considered, the assumption is that cost savings will follow either through using a specialized firm and capitalizing on their expertise in their core competency or by achieving economies of scale. What appears to be missing is a clear framework to help managers determine which services and functions should be considered for outsourcing and what contracting instruments should be used to reduce future transaction costs in order to achieve the desired savings. The concepts of Transaction Costs Economics (TCE) and asset specificity could provide this framework. A core component of TCE recognizes that the proper selection of the government’s oversight framework is paramount to achieving the goals that outsourcing seeks to realize. While the A-76 circular helps define which items should be considered for outsourcing, it does not address many potential problems that are inherent in outsourcing actions.

### **B. OBJECTIVE**

The objective of this research is to determine to what extent the concepts of transaction costs economics can be applied to the Department of Defense outsourcing procedures. Some of the research questions this research will answer include:

- What do current DOD regulations require with respect to categorization of product and services being considered for outsourcing?
- How well do current regulations prepare managers for upcoming contracting actions?
- Can TCE concepts be applied to assist future managers in the outsourcing decision?
- What categories or “bundles” of goods and services should be recommended for outsourcing?

### **C. BENEFITS OF THIS STUDY**

The findings of this study can be used in making and monitoring outsourcing decisions. The research could provide managers a framework in which to evaluate the goods or services under consideration for outsourcing and offer guidance and recommendations for bundling and unbundling particular activities to be outsourced. Additionally, the framework should be helpful to contracting officers in structuring a contract that protects the government while providing adequate incentives to the contractor.

### **D. SCOPE AND METHODOLOGY**

The methodology for this work is the application of TCE to the DOD outsourcing process to improve outsourcing decisions and achieve lasting cost savings. The literature reviewed includes that of transaction cost economics, defense acquisition reform and the current DOD outsourcing process. Literature review sources will include, but are not limited to Department of Defense regulations, academic research studies, Internet articles, and General Accounting Office reports.

## **E. ORGANIZATION OF STUDY**

- Chapter I. Introduction: This chapter identifies the purpose of the thesis, primary research questions, the methodology and potential benefits of this study.
- Chapter II. Transaction Costs Economics (TCE) for Defense Acquisition Managers: This chapter provides background information regarding the theory of Transaction Cost Economics so that it may be discussed later in reference to outsourcing.
- Chapter III. A-76 and TCE: Understanding the Relationship: This chapter provides background information regarding the way in which the outsourcing procedures are currently conducted and offers a TCE perspective throughout the various steps of the A-76 process.
- Chapter IV. Applying a TCE Framework to the A-76 and Outsourcing Process: This chapter addresses asset specificity, complexity and frequency and how it affects the A-76 process. A framework in which to apply those three factors is also offered and contract recommendations are discussed.
- Chapter V. Summary: This chapter summarizes the research findings, offers conclusions, answers the research questions and provides potential areas for additional research.

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## **II. TRANSACTION COSTS ECONOMICS (TCE) FOR DEFENSE ACQUISITION MANAGERS**

This chapter is intended as a guide for Department of Defense (DOD) managers to familiarize themselves with the principles of Transaction Cost Economics (TCE), and to demonstrate how these principles can be applied to improve outsourcing decisions. Since the demise of the Soviet Union fiscal constraints have greatly changed the way in which DOD conducts business. Applying Office of Management and Budget (OMB) Circular A-76, DOD has become increasingly reliant on outsourcing as a means to cut costs and improve efficiency.

Outsourcing and competition offer the prospect of lowering costs and improving performance by injecting private market efficiencies into government operations. While outsourcing has been used to a wide extent by DOD, there has been frustration expressed that the projected savings either never appear or are quickly eroded. For DOD to actually realize the cost savings that outsourcing promises, managers need to understand the market forces and incentives that affect these types of transactions. Moreover, DOD should not focus on outsourcing as strictly a short-term cost cutting procedure but as a mechanism that offers both improved efficiency and lower costs over the long run.

When viewing reported savings, it has been shown that the savings come mainly in the form of a reduction in permanent employees, not through a quantum leap forward in efficiency (Brower: p. 64). Moreover, these personnel savings often the result from a reduction of work scope. Sometimes this reduction of scope is intentional, such as when a function is no longer required. Unfortunately, many times the reduction is a result of the DOD agency doing a poor job of defining the work package that is to be performed by the contractor. This can leave DOD with a contract that does not fully meet the needs of the agency, thus requiring the contract to be renegotiated (Gates: pp. 46-48).

These problems and others lead some outsourcing critics to say that the outsourcing process is not working and does not achieve real long-term cost savings. However, it is also possible that personnel charged with making the outsourcing decision do not fully understand the economic forces at work. TCE seeks to explain why certain

transactions are well suited to be competed in the open market and why some functions are best retained by the organization. Oliver Williamson, the recognized founder of TCE, points out that TCE seeks “economizing on transaction costs” (Williamson: 1985 p. 52). At the heart of TCE is the proposition that transactions that have certain characteristics (a higher level of asset specificity, increased uncertainty and reduced frequency) require more complete contracts and enforcement clauses to reduce the prospect of opportunistic behavior.

This chapter will describe the major components of TCE and how they affect outsourcing within DOD. The critical “make or buy” decision will be investigated in the context of TCE. This will lead to a discussion of the concepts of opportunistic behavior, asset specificity and contracting in terms of the DOD outsourcing process.

#### **A. THE “MAKE OR BUY” DECISION-THE POTENTIAL FOR OUTSOURCING**

At the heart of outsourcing is the “make or buy” decision. TCE seeks to determine if it is in a firm’s best interest to contract out a function or if it is more economical and efficient to produce those goods or services internally. The assumption is that firms will choose to procure goods and services from the marketplace if they are less expensive and of the same or better quality. Through their outsourcing decisions firms can uncover and concentrate on their core competencies.

Organizations must evaluate all relevant costs to determine if goods or services can actually be provided at lower cost by an outside firm, and still preserve (or increase) the quality. If costs savings are gained at the expense of quality, the trade-off has to be assessed and there may not be sufficient reason to buy the goods or service from an outside firm.

All costs must be considered in the analysis, both implicit and explicit. Contracting costs and monitoring costs must also be factored into the decision. Intangible costs, such as loss of control over the function may also be a factor. Along with intangible and tangible costs, internal and external costs must also be factored into

the decision process. Internal costs exist regardless if the activity is performed internally or by the market. Contract administration costs will be borne if a function is outsourced, while infrastructure costs exist if the function is retained. Infrastructure costs are not always eliminated when a function is outsourced. Often the infrastructure is required by the contractor in order to fulfill the contract or may have disposal costs that are overlooked when the organization is considering outsourcing. If these assets are sufficiently specialized, this raises the challenge of asset specificity leading to opportunistic behavior that will be discussed later.

By participating in the free market, items are often cheaper due to competition. The more common the item, the more likely the market can provide reduced costs over making the goods in-house. Along with reduced costs, the market can often provide improved quality through competition. In contrast, the more complex and scarce an item is, and the more specialized the resources required to produce it, the more likely that an organization is better off retaining the function. A good example is the comparison between basic office supplies and information technology services. No organization would choose to make their own paperclips or pencils as the competitive market provides a wide array of choices that can provide these items at a high level of quality at a low price through specialization and economies of scale. The converse is the highly complex arena of information technology and computing services. While there are numerous firms in the market place that can provide this service, the function is so vital to an organization that the decision to outsource cannot be made on price alone. The complexity of the function must also be considered, as requirements become more complex, the fewer the firms that can provide the service. With less competition comes higher prices and greater contracting and monitoring costs. If transaction costs and governance costs become too expensive, it is in the firm's best interest to produce those items internally.

## **B.     OUTSOURCING PROBLEMS**

Outsourcing is fraught with problems, many addressed in the rich literature of TCE. As mentioned before, the more complex a function, the more problems that must be addressed to determine if outsourcing a function is in the best interest of the government. The concepts of opportunistic behavior, asset specificity and contracting in TCE offer insights to improve outsourcing decisions.

### **1.     Opportunistic Behavior**

Opportunistic behavior has its roots in the foundation of economics, specifically the study of incentives. Oliver Williamson, the founder of modern transaction cost economics, refers to opportunistic behavior as “self-interest seeking with guile” (Williamson: 1985 p. 72). A specific form of opportunistic behavior, referred to as a “holdup”, occurs when a firm can exercise control of a key resource to exploit or hold up other firms that require their services. TCE provides insight to determine if a firm will act in an opportunistic manner after a contract has been negotiated and signed. What is important is that the firm recognizes that opportunistic behavior could exist in certain transactions and to use contracting instruments to reduce its effects. When evaluating if it is in your firm’s best interest to use the marketplace for goods and services, you must determine if the supplier is in a position in which they could exploit your firm through opportunistic behavior. This can occur both supplier to customer and customer to supplier.

Going back to the examples of office supplies and computing services, it is unlikely that a firm dealing in office supplies could holdup a customer, due to the competitive nature of the marketplace. If an office supply company tried to raise the price, the customer would simply find another supplier, as the marketplace has many office supply choices. However, in the example of computing services being provided by an outside firm, there are more opportunities for holdup charges. First, the two organizations are probably bound by a fairly complex contract, so in the near term the buyer cannot use alternate suppliers to mitigate the opportunistic behavior. Second, the

customer has likely become extremely reliant on this service and cannot afford extended service interruptions when there is a problem.

The computer firm can exercise opportunistic behavior in several ways. It can follow the contract strictly, only performing functions listed explicitly in the contract. The supplier can also react to a crisis slowly, while still fulfilling their responsibilities and could use this as an opportunity to seek additional compensation. Contingency situations often can give rise to opportunistic behavior on the part of a supplier, particularly if the contract between the two firms does not address contingency or emergency scenarios.

## **2. Asset Specificity**

Asset specificity is at the heart of transaction costs economics. The principles of asset specificity allow us to place particular goods and services into categories with different degrees of asset specificity in order to evaluate the nature of the transaction and the possibility that opportunistic behavior may occur.<sup>1</sup> The more specific an asset is to a transaction, the more likely that a holdup could occur. When asset specificity is low, the potential for opportunistic behavior is low. There are six commonly accepted categories of asset specificity in TCE from the literature (Melese and Franck: 2002):

- Physical Asset Specificity refers to an asset or piece of equipment that is required to produce a particular product.
- Human Asset Specificity is the knowledge and skills that individuals acquire while working for an organization.
- Site Specificity are assets that are bound together by location in order to produce a product. An example of this would a lumber yard that locates itself adjacent to a forest that is being harvested, or a shipyard that locates itself near a naval installation.
- Dedicated Asset Specificity are items that are required to manufacture a product for a particular buyer. This could be dedicated software between a merchant and supplier to track inventory and orders.

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<sup>1</sup> When a transaction is reliant on a specific asset, the firm that controls that particular asset has great power, and can act opportunistically, either by raising prices or exhibiting other opportunistic behavior that will be discussed later.

- Brand-name Asset Specificity exist where investments made by one party are affected by the reputations or actions of another firms, such as in franchises.
- Temporal Asset Specificity are investments in time-critical areas or bottleneck activities that have a great impact on delivery schedule and costs.

Highly specialized functions tend to have greater risk and higher costs. By evaluating the degree of asset specificity, government contracting agents will be better able to understand the hazards ahead. Transactions that involve a greater degree of asset specificity, higher uncertainty and are not frequently conducted tend to require more complex contracts, and more explicit monitoring of the transactions and contracts. If these factors lead to sufficiently higher costs, then the organization may choose to retain the function internally.

## **C. CONTRACTING**

Contracts are used to mitigate risk and facilitate exchanges of goods and services. Specifically, a contract that is carefully constructed protects the interests of both the buyer and the seller and reduces the chance for holdup opportunities for both parties. Williamson defines the world of the contract as one of planning, promise, competition and governance (Williamson, 1985; p. 30.). In order for a contract to be effective, contracts need to address these four areas. As asset specificity increases, these four items become increasingly difficult to manage.

### **1. What are Contracts Supposed to Do?**

Firms enter into a contractual agreement because they will both benefit from the exchange of goods or services. This is at the heart of economic principles. Effective contracts protect the interests of the buyer and seller. In a perfect world, the buyer and seller act in accordance with the signed contract, ultimately benefiting both parties.

Contracts should also reflect the level of transaction complexity. When buying office supplies, the contract can be as simple as the single purchase of pens and paper

with no requirement of future transactions. More complex functions, such as the outsourcing of a firm's information technology tasks, will require contracts that mandate required levels of performance, incentives for sustained superior performance as well as grievance procedures to resolve instances when one party feels the other is not fulfilling the contractual agreement. Effective governance or control mechanisms are set in place to not only ensure that all parties perform as agreed upon but to help resolve disputes that occur. When a dispute arises, there should be instruments in place that allow for the agency to resolve the issue in a way that maintains the mutually beneficial relationship of the contract. Litigation is costly and should be used only as a last resort.

## **2. Variables that Impact Effective Contracting**

According to the concepts of TCE, the level of asset specificity, complexity of the task and frequency of the transaction have a great impact on the effectiveness of a contract. Contractual agreements must not be so rigid that they do not allow flexibility or the expected benefits from the anticipated exchange will not be realized. Contracts that have little flexibility can subject firms to a holdup. Striking a balance between effective controls and flexibility for contingencies is what makes complex transactions so difficult and perilous. Additionally, all parties involved in a contract have it in their best interest to develop an effective contract and enforcement procedures.

The first chance that a firm has to exhibit opportunistic behavior is during the negotiation phase of the contract. Firms may not always act in an ethical manner during the initial phases of the contracting process. In this instance, it is imperative that the government and DOD recognize this behavior and either work through the differences, seeks another firm with whom to conduct business choose to vertically integrate. In this instance, it is imperative that effective and enforceable governance mechanisms be put in place. It is important to note that even with considerable planning and coordination it is virtually impossible to write a contract that accounts for all eventualities.

If we review our example of the office supplies, contracting actions should allow the buyer the flexibility to change suppliers easily in order to reap the benefits of the competition. However, a detailed contract would involve transaction costs that result in

little benefit to the buyer. Conversely, when dealing with the complexities of information technology services, great skill and care must be demonstrated in constructing a contract. Here a contract would need to have clauses that delineated required minimum performance standards as well as flexibility to allow for unforeseen circumstances, like natural disasters and quick resolution in the event of loss of service. If there is little flexibility in the contingency area, this could lead to an instance where supplier could exhibit opportunistic behavior.

Long-term contracts present their own challenges. In dealing with long-term relationships, it is nearly impossible to anticipate how the future will unfold. As time passes, the market will likely change or evolve in unforeseen ways. Couple this with complex transactions, and long-term contracts can transfer a great deal of power to the supplier unless forces of the competitive market can be reintroduced during the contract period.

#### **D. TCE: AN EXAMPLE**

An excellent example that illustrates the various aspects of TCE can be found in Paul H. Rubin's book, *Managing Business Transactions* (The Free Press: 1990). The example is of a firm that decides to enter the garbage collecting market in a municipality. In this case we will assume that the firm will be using a private landfill owned by a firm (other than the city) and that the firm has already been awarded the contract from the municipality.

First, the firm will need to acquire the dump trucks required to collect the garbage, facilities for maintenance, truck storage and office space for general administration of the business. It must hire drivers for the trucks and managers familiar with the business and the city. In order to use the services of the landfill, the collection company needs to negotiate a dumping price in advance with the landfill in order to determine their bid price to the city for the garbage contract. If the price of accessing the landfill is too high, the garbage collection company will not enter this market, as it will not be profitable.

Once the trucking firm begins to use the landfill, the operators of the landfill have the opportunity to impose a holdup on the trash firm because the garbage firm is dependent on the use of the landfill. If this is the only landfill in the immediate area, it could seek additional fees for dumping of garbage. The operators could impose restrictions on how many trucks may be in the landfill at once or how many loads of garbage are dumped in one day, which could result in the garbage collectors being unable to keep up with the current workload. It is essential that the garbage collection firm negotiate a contract in advance addressing the specific prices and procedures for use of the landfill. A well-drafted contract, negotiated in good faith, could eliminate many of the holdup possibilities.

Assume that the contract was vague and that the landfill owners were able to exhibit opportunistic behavior that would adversely impact the trucking firm's business, even causing them to become unprofitable. The trucking firm could choose to leave this market and enter into a different business in the same town (such as the hauling of construction materials) or leave the town altogether and seek to enter in the garbage collection business in a different city. First, consider the human asset specificity factors. These are the managers and personnel that have an understanding of the garbage business and specifically, the garbage business in this town. If the business decides to go into the trucking of construction materials, the skills and knowledge of the garbage business will be lost. If the firm chooses to move and try the collection business in a different city, the expertise that had been gained in this original market will be surrendered.

Next is the consideration of the physical asset specificity as it relates to the trucks, facilities and administration buildings. If you assume that the trucks are just standard dump trucks, then they could easily be used in the construction business. However, most garbage trucks today are automated with an arm to empty the garbage can and a compactor in the truck. If you have this kind of asset, it will not easily transfer to the construction business without a major configuration change. The same is true for maintenance facilities and the administration buildings. While the administration buildings will probably be suitable for either task, the maintenance facilities that will be needed will vary based upon the specific capabilities of the trucks. Facilities for the maintenance of the automated portion of the garbage trucks will not be useful if the

trucks are converted. Some maintenance equipment could probably be sold, but the firm will likely incur a loss. If the firm decides to relocate to another city altogether, all facilities must be sold and the company will need to build or acquire facilities in the new town.

Another consideration is the one of site specificity. Some garbage hauling businesses may choose to locate their offices and maintenance facilities near the landfill in order to reduce the transportation and labor costs of trucks returning empty at the end of the day from a landfill across town. If the company decides to exit the garbage business and enter the construction business, then the location of the facilities may not be in an area that is not advantageous for the firm in this new market. If you decide to move the garbage business to another market, finding a buyer for your facilities near the landfill could be difficult, as a location near a garbage dump may not be attractive to many potential buyers.

There are other considerations, as well. If the firm decides to become strictly a dump truck business, they will need to assess the marketplace to determine if they can be profitable in this arena. There are also the costs of moving the business to a new city, such as the distance of the move, and which cities will be seeking new contracts in the timeframe in which you are looking to relocate.

In light of these issues, the garbage collection company may choose to vertically integrate by acquiring a landfill to eliminate the possibility of opportunistic behavior. The owners of the garbage hauling business have a greater desire to buy the landfill than does any other firm. When two or more specific assets are closely linked, the chance for opportunistic behavior is greater than if the assets have separate owners (Rubin: p. 8). Since the landfill is a specific asset that is required for the garbage company, there is a greater chance that a holdup may occur if owned by a separate company. This makes a compelling case for vertical integration even though, owning and managing a landfill is not the core business the owners of the hauling company were seeking. But, in order to be viable as a garbage collection firm, acquisition of the landfill may be necessary.

## **E. SUMMARY**

The framework of TCE can help managers within the Department of Defense to understand the complexities of outsourcing. Asset specificity, complexity and frequency of the transaction will have a great impact on how much cost savings can be realized in the long term. Additionally, understanding how asset specificity and opportunistic behavior are related will give leaders in DOD a tool that can help them assess which items should be considered for outsourcing based upon achievable savings and increased efficiency. Using the example of a business entering into the municipal garbage collection business shows that asset specificity and opportunistic behavior can make a seemingly simple exchange of goods and services difficult. By understanding these concepts leaders will be better equipped to evaluate outsourcing candidates to determine if the projected savings are realistic.

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### **III. A-76 AND TCE: UNDERSTANDING THE RELATIONSHIP**

The Department of Defense is one the world's largest purchasers of goods and services, and it is important that outsourcing is cost-effective. A key assumption of the Office of Management and Budget's Circular A-76 is that the marketplace can provide some products and services more economically and efficiently than if they are produced internally. In order for DOD to capitalize on the marketplace and the concept of competition, defense leaders need to understand how Transaction Costs Economics (TCE) and the process of outsourcing are related. This chapter will evaluate the A-76 process and how the concepts of TCE relate to the major stages of the current system.

#### **A. THE PURPOSE OF A-76 CIRCULAR**

OMB Circular A-76 sets forth procedures to determine which government activities should be performed internally or by outside contractors. A key tenet of the circular is the belief that competition will yield savings, which can be used to modernize equipment and improve readiness. This is not unique to the federal government; business has long realized that items, which are not a part of their core competencies, can often be purchased from another firm, which will result in lower prices and/or improved quality.

Along with the cost savings is the belief that the government should not compete with it's own citizens. OMB did recognize that there are instances in which commercial sources may not be available or appropriate. For instance:

- The government may engage in inherently commercial activities if it can be determined that the function is critical to combat effectiveness or that mission effectiveness will suffer as a result of outsourcing. An example of this would be providing meals to soldiers in the field. Clearly there are commercial firms that can provide meals that are less expensive and taste better than are currently available. However, concerns over how well the unit could operate in a hostile situation would outweigh the advantages of outsourcing.
- A commercial source is not available or cannot provide the product or service that meets the governments requirements or in a timely manner.

- Another federal agency can provide the good or service. Often times other government agencies are required to compete under the auspices of the A-76 framework.
- Procuring from a commercial firm will result in a higher cost to the government than if the item is produced internally.
- Items that were inherently governmental in nature are to be excluded from consideration for outsourcing (OMB A-76 Circular).

It must make economic sense to outsource an item or function. Along with the projected costs, less tangible considerations are important to ensure that the intended savings are achieved.

## **B. THE A-76 PROCESS**

There are eleven distinct stages in the A-76 process that lead either to the government retaining the function or signing a contract with a commercial firm.

### **1. Packaging**

Packaging is the first step in the A-76 process. This step requires agencies to identify commercial activities within their organization that are to be studied. The organization should evaluate commercial activities and package or “bundle” them in a logical fashion. Functions that are not linked should be separated in order to provide the greatest amount of competition. For example, a work package that included information technology support and janitorial services, would greatly limit the number of commercial firms that would be able to bid on the contract.

This step should be completed prior to the public announcement of the government’s intention to seek bids. The Federal Activities Reform Inventory (FAIR) Act of 1998 in conjunction with the OMB Circular A-76, directed all federal government agencies to identify their commercial activities and to submit that list to OMB on an annual basis. This list can be accessed by commercial sources that wish to compete for that business.

This step is critical, if bundles are not carefully constructed, the agency could be providing the contractor with the ability to exhibit opportunistic behavior. As more functions are included in a package, the possibility exists that fewer contractors will be able to compete for contract. Defense managers should be conscious of the implications, and ensure that functions are clearly described and realistically bundled. Recognizing the implications of asset specificity, complexity and frequency in this early stage will allow defense managers to choose functions that when bundled together minimize the potential of opportunistic behavior by the contractor.

## **2. Public Announcement**

The stage begins with the notification of Congress that a commercial activity has been designated for competition under A-76 guidelines. At the same time, an A-76 Study Team is formed and the local federal workforce and the community are notified of the intention to initiate an outsourcing study. If the study includes work that is already being performed by an outside contractor, the current contractor should be notified promptly. It is important that the workforce that could be affected by the study understands the goals of the study and the cost comparison model that will be used to assist in the ultimate decision.

It cannot be stressed enough how important effective communication with the existing workforce will be. To effectively evaluate the commercial activity being studied, the current workforce will play a crucial role. The employees will have considerable input into how the requirements from vendors will be assessed. This is a scenario in which the federal employees could exhibit opportunistic behavior by intentionally overstating operating costs or the scope of the function being studied. More complex operations will require more detailed work descriptions in order to adequately illustrate the work to be performed. Additionally, contractors that win A-76 studies often need additional workforce to compete the work described in the contract; the commercial firm frequently hires federal employees of the function that has been outsourced.

### **3. Formulation of Performance Work Statement (PWS) & Quality Assurance Surveillance Plan (QASP)**

This stage marks the point in which the requirement and products that the government is seeking begins to be articulated. This phase is sometimes referred to as Initial Acquisition Actions (Website: Share A-76). The Performance of Work Statement (PWS) is essentially the requirements document. The PWS outlines the product requirements, including timeframes and performance measures and standards. Eventually the PWS becomes section C in the Request for Proposal (RFP) that is issued by the contracting element assigned to this task. Development of the PWS is critical. This is the document that will be used by commercial firms to develop their plan to bid on the project or the creation of the Most Effective Organization (MEO) by the in-house organization. All costs estimates, costs in the Government Management Plan and associated costs, along with contractor's bids and proposals are evaluated against the provisions listed in the PWS. An ineffective or incomplete PWS could result in the contracting of products or services, which do not meet DOD's needs or otherwise do not reflect what the agency is seeking.

The Quality Assurance Surveillance Plan (QASP) describes procedures that DOD and the government will use to verify that contractor's proposal meets the requirements listed in the PWS. The QASP will define metrics and other performance measures that are to be used in the cost comparison. When metrics and performance measures are defined, it is preferable to use as few as possible, and items that can be effectively measured. If too many metrics are included in the QASP, contracting and monitoring costs can become prohibitive and erode intended cost savings. Additionally, too many performance standards can create a situation that can stifle competition because some firms may choose not to bid. Understanding of the concepts of TCE would help managers and contracting officers understand that the monitoring costs are real and should be incorporated into the cost estimates from the government and contractors.

This is another opportunity to mitigate risk. Effective PWS and QASP will help identify areas in which contractors can exhibit opportunistic behavior. These documents need to be carefully crafted to represent DOD's needs while maintaining realistic performance and monitoring standards that protect both the government and the

contractor. Lack of attention to detail will most certainly adversely affect the government, but can also have a negative impact on the commercial activity providing the services. Contracts that must be re-competed before the initial contract period is over often result in higher costs through increased work scope along with potentially fewer commercial firms that may be willing to consider the new proposal (Website: Share A-76).

#### **4. Solicitation**

In this step, the government develops and issues a Request for Proposal (RFP), which seeks bids and proposals from commercial firms. Using the PWS, the contracting officer and key leaders from the government agency, determine which type of contract will be used, review the PWS for accuracy, and develop the Source Selection Plan. After that, the solicitation is released to the public, allowing contractors to offer proposals and bids to the government.

Leaders in DOD have frequently allowed too much power to be transferred to the contracting officer in this phase. If asset specificity, frequency and complexity are significant issues, then agency managers will have the best understanding of the challenges involved. If the contracting officer does not select a contract which protects the government while providing the appropriate incentives for private firms to compete for the business, the outsourcing action may result in failure due to lack of interest from commercial firms. If an A-76 study results in no bids from the market, the government automatically retains the function.

#### **5. Government Management Plan**

The Government Management Plan identifies staffing, organizational structures, resources, transition procedures and inspection plans that are necessary to make certain that the agency can perform the commercial action in an efficient manner. The Government Management Plan contains four documents, the Most Efficient Organization (MEO), In-House Cost Estimate (IHCE), Technical Performance Plan (TPP), and Transition Plan (TP).

- The Most Efficient Organization is the document that contains the government's estimate for performing the commercial activity in-house as described in the PWS. The MEO outlines the proposed organizational structure, administrative and staffing functions, as well as operating procedures the agency will use if the commercial activity is retained. The MEO is probably the document that receives the most attention during the A-76 process and lays the foundation for the Government Management Plan as a whole.
- The In-House Cost Estimate contains the cost estimate for the MEO. Specifically, the IHCE defines costs such as overhead, staffing, severance costs and other miscellaneous costs. Costs listed in the MEO are the costs used in IHCE, it is important the MEO be accurate, otherwise the IHCE will not be accurate.
- In the Technical Performance Plan, details of how the government agency will carry out the requirements in the PWS if the A-76 study results in the MEO retaining the function.
- The Transition Plan outlines the transition process to the government MEO or to the contractor support if the function is outsourced.

These documents, if carefully constructed, limit the potential for opportunistic behavior. A consistent problem within the federal government, and in particular DOD, is that support documentation for A-76 studies lacks sufficient management oversight, subsequently understating the government's requirements (Weber: p24).

## **6. Independent Review**

During the Independent Review phase, the PWS, QASP, MEO, IHCE, are reviewed by an Independent Review Officer (IRO). All documents are evaluated to ensure that the requirements listed are adequate and realistic. The IRO should be an agency official who has not been involved with the development of the Government Management Plan. He/she should have the technical expertise to evaluate the various documents and discern if cost estimates are reasonable and quantifiable. In some scenarios, the IRO may need to seek outside assistance when dealing with complex requirements or processes. If deficiencies or errors are found in the Government Management Plan, changes can be made to the applicable documents. The IRO must certify any changes, which must be completed prior to receipt of contract offers.

## **7. Negotiation & Selection of Commercial Firm to Compete with the MEO**

This phase begins with the contracting officer holding discussions with the firms that have submitted proposals and bids. The form of communication can be either written or verbal. More complex commercial activities that are being studied should be conducted in writing in order to create a paper trail in the case of dispute. After discussions, each firm is given the same amount of time to respond with a revised proposal. Finally, based upon the proposals and how well they address the PWS, a single firm is selected to compete with the agency's MEO.

Managers from the agency being studied should engage the contracting officer to ensure that the proposal that is ultimately accepted to compete against the MEO in the cost comparison can fulfill the requirements of the PWS. Contracting Officers are often unfamiliar with the functions that the A-76 study is considering. Once the proposal is selected to compete with the MEO, there is little recourse.

## **8. Cost Comparison**

At this stage the proposal that was selected is compared against the MEO. Before the tentative selection is made, the Source Selection Authority (SSA) makes a determination that the government's technical proposal will offer the same level of support and performance as the contractor's proposal that was selected in the previous stage. If the government's TPP is found to be deficient, it is returned to the government agency for revision. Once the TPP is revised and accepted by the SSA, the contracting officer then opens both proposals (government and contractor) and performs a cost comparison. Based upon this cost comparison, a tentative decision is made on whether to accept the MEO or the contractor's proposal. The final selection between the two proposals is made solely on lowest cost.

In order for the product or service to be outsourced, the contractor's proposal must meet the minimum cost differential requirement. The minimum cost differential requirement states that the contractor's proposal must be ten percent less than the government's IHCE or save the government \$10 million over the performance period, whichever is less. The minimum cost differential requirement has caused some

commercial firms not to bid in A-76 studies due to the costs involved in preparing a bid that is in fact not the lowest cost (Thompson: p. 34). However, this provision attempts to protect the government from using lowest cost as the deciding factor without accounting for transition costs and disruption of service (Website: Share A-76). Once the tentative decision is made, in accordance with the Federal Acquisition Regulations and service specific guidelines, the contracting officer informs the Commanding Officer of the agency being evaluated prior to official announcement of the tentative decision.

## **9. Administrative Appeals Process**

During this appeal process, administrative appeals can be made based upon errors in the cost comparison process. This review period typically lasts twenty calendar days after the publication of all supporting documentation in the selection process. The contracting officer has the option to extend this period to a maximum of thirty calendar days in more complex competitions.

Appeals are not just limited to the contractor selected in the tentative decision or the government agency' MEO. Any contractor that submitted a formal proposal, government employees that are affected by the outsourcing decision, or another governmental agency that has submitted a proposal through an Interservice Support Agreement (ISSA) can submit an appeal. All appeals must be in writing and received by the contracting officer within the review period.

## **10. MEO or Contractor Implementation**

Upon completion of the public review period, it is time to implement the MEO or transition to contractor support. If the contractor's proposal is not less than the MEO (less the minimum cost differential), the MEO is implemented and the function remains with the government for the designated period. However, if the contractor is awarded the contract, the Transition Plan from the Government Management Plan is implemented. Whatever the outcome of the study, managers must be aware to avoid additional or undue turmoil within the organization. The Transition Plan previously developed is to be carried out and will include items such as personnel management issues, transfer of

equipment or inventories, training and procedural changes. If the government wins, the MEO proposal, along with the PWS, government management plan and the QASP will guide the government's actions.

#### **11. Post-A-76 Actions**

Now the winner of the A-76 study begins to perform duties as described in the PWS. Regardless of who assumes the commercial activity responsibilities, the QASP is put into place. In the case of the government retaining the function, the MEO and QASP should be reviewed periodically. Typically the MEO is reviewed as the first year of operation is completed to verify that the agency has implemented the MEO as was proposed. The QASP should be updated as necessary. At the end of the contract period, the activity can be re-competed regardless of who was awarded the contract.<sup>1</sup>

### **C. OUTSOURCING & A-76 CHALLENGES**

With over forty percent of major U.S. business firms outsourcing at least one major function (Brower: p. 64), it is reasonable to assume the federal government and DOD can achieve cost saving through outsourcing. But, as with any potential solution, there are often challenges and problems that follow. While there are many problems with the A-76 process, the following appear to be the most pressing: perceived unfair advantage to the government and overstated cost savings.

#### **1. Perceived Government Advantage**

At the heart of the debate regarding government advantage is the minimum cost differential requirement. With the ten percent or \$10 million rule, government functions may be retained in order to preserve continuity rather than switch to a contractor over relatively small savings. Most cost savings that are realized, regardless of who wins the

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<sup>1</sup> Contracts are re-competed automatically at the end of the contract period. Whether the PWS and contract structure is drastically restructured or remains basically untouched will be based upon the input from the customers, stakeholders and contracting officer. Contracts that fail to achieve "advertised" cost savings are likely to be restructured.

A-76 study, comes in the form of personnel savings. As more A-76 studies are completed, many defense contractors have grown so frustrated, that some firms are bidding on less commercial activities (GAO: NSAID-00-106). Some of this distress may be unfounded, according to a 2001 GAO study (GAO: NSAID-01-20) GAO reported from 1995 through 2000 that commercial firms won fifty-five percent of the A-76 competitions.

The minimum cost differential requirement is not the only concern that commercial firms have with the A-76 process. Defense contractors have long expressed concerns over the antiquated accounting systems that DOD uses allowing the government to underestimate overhead rates while commercial firms are required to use Generally Accepted Accounting Principles (GAAP) standards. Further clouding the issue is military manpower. There have been cases in which the government agency was able to transfer the active duty members to another portion of the agency, which allowed this salary to be eliminated from the MEO cost estimate. Later it was found that the military member still performed some of the functions for the agency under the provisions of the PWS and MEO (Celarier: pp. 54-58).

## **2. Overstated Cost Savings**

It has long been suspected that DOD estimates of cost savings from outsourcing are overstated or incorrect. Some of the problem refers back to the problem of adequately developing the Performance of Work Statement. Additionally, projected savings have not been realized because some in DOD have chosen not to release federal workers, but instead reassigned them to new duties (Weber: p. 24).

The General Accounting Office has conducted scores of studies regarding outsourcing and anticipated cost savings. Below is just a sampling of problems that DOD has experienced in achieving real cost savings:

- Costs of A-76 competitions were not included. In some instances, this cost alone negated anticipated savings (GAO: NSAID-98-122).
- Projected cost savings are overstated. In 2000, DOD revised many cost savings estimates and reduced its cost savings goals. Furthermore, GAO concluded that uncertainty with DOD's long term cost models call into question many long-term projected savings (GAO: NSAID-00-106).

- In a 1998 GAO report on outsourcing of DOD logistics functions, GAO concluded that \$4 billion out of \$6 billion in projected savings were overstated due to errors in estimates, dubious assumptions and legal and cultural barriers (GAO: NSAID-98-048).

Pressure to cut costs and “find money” within the Department of Defense has given rise to officials overstating savings. When this occurs, instead of saving money, money is taken away from other projects to cover the higher than projected costs.

#### **D. TCE ISSUES IN THE OUTSOURCING PROCESS**

By studying the current outsourcing process, it is clear that the opportunity to achieve savings and to limit opportunistic behavior exists. The process itself can range from eighteen months to over two years, with a minimum of eleven distinct phases. Initially, it is important that the managers within the agency undergoing the A-76 study understand how to bundle or unbundle what is being considered for outsourcing. While this may sound obvious, initial stages will ultimately determine if the study actually saves the government any money.<sup>1</sup>

The opportunity to apply the lessons from TCE is primarily available in the initial stages of the process. Once the A-76 study begins, the process gains momentum. The only thing that can stop an A-76 study from completion once started is a lack of interest from commercial sources. If the process is not actively managed from the beginning applying TCE concepts, projected savings will be illusive. For example, if a simple fixed price contract is selected for a complex function, it may not provide the flexibility, and incentives and governance mechanisms needed to achieve cost savings.

Because TCE principles are developed from actual experience, many managers use TCE without knowing it. For instance, when a base commander is conducting a study regarding the outsourcing of depot level maintenance a number of questions arise. What kind of asset specificity is applicable? Should the contractor perform the maintenance using government facilities or the firm's? Not only should physical

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<sup>1</sup> Unbundling too many functions could lead to an excessive number of contractors, which could give rise to higher coordination costs.

(equipment) asset specificity be considered, but also human asset specificity. If this function is outsourced, how will the loss of highly trained personnel limit the government's ability to perform or manage this activity in the future? If it is just the maintenance on vehicles in the motor pool, there is less of a chance for opportunistic behavior. However, if the government is using a private firm to perform depot level maintenance on fighter aircraft at a particular military installation, there is greater opportunity for hold-up.

The next chapter will provide a framework for managers to evaluate outsourcing actions from the perspective of asset specificity, complexity and frequency. It will help provide recommendations for contracting instruments and warning signals of when outsourcing of items may not be cost-effective.

## **IV. APPLYING A TCE FRAMEWORK TO THE A-76 & OUTSOURCING PROCESS**

Understanding the concepts of Transaction Cost Economics (TCE) can provide DOD leaders and managers a better understanding of outsourcing in general, and the A-76 process in particular. Just understanding the concepts of TCE will not necessarily help the decision-maker, but being able to take the concepts and overlay them onto the DOD outsourcing process could be useful. This chapter will provide a framework to apply TCE to A-76 studies using the three key concepts of asset specificity, complexity and frequency. Within each concept, a red/yellow/green proposal will be offered to help managers identify potential problems. The stop light system is subjective, and will require the thoughtful consideration of managers and leaders that are involved in the A-76 study. Furthermore, discussion on how contracts could be used to mitigate risk and facilitate a mutually beneficial outsourcing relationship will be offered.

### **A. ASSET SPECIFICITY**

As discussed in Chapter II, there are six distinct categories of asset specificity: Physical Asset, Human, Site, Dedicated Asset, Brand-name and Temporal. Each type brings different challenges. It is not important to discuss each type of asset specificity in detail in order to understand and recognize potential problems.

Consider the case of Fort Rucker's A-76 competitions for pilot training and aircraft maintenance (Tighe, et al: 1997; pp. 28-36). Fort Rucker, located in southeastern Alabama, is the U. S. Army's primary aviation training base. Contractors have performed primary pilot training and aircraft maintenance for over 30 years. While these functions are under separate contracts, they are linked and provide excellent examples of how asset specificity affects A-76 competitions and subsequent contracts. Both contracts are recompeteted every five years.

Primary flight training is 22 weeks long. The training consists of both classroom instruction and actual in-flight training and evaluation. The Army supplies the actual

classroom facilities and aircraft, while contractor support consists of instructors and some classroom materials. Through the years, Army leadership was satisfied with the quality of primary flight training and was concerned over pressure in the late 1980's to recompetete the contract and possibly to restructure the contract in order to produce savings. The same contractor had won all previous A-76 competitions. Fort Rucker leadership was concerned that if a new competitor were to win, there could be a considerable learning curve to overcome. Also, previous contracts had clauses that allowed for changes in workload and contingency operations. New contracts were to be structured to remove that flexibility in order to achieve cost savings.

Fort Rucker leadership unbundled the activity, determining that the only portion that would undergo an A-76 competition would be the audio-visual support function that supported the existing contracted flight instructors. The contract regarding the flight instructors and maintenance facilities would remain in place in its current state. The new contractor for audio-visual support offered a potential cost savings of forty percent over the MEO's projected savings of seventeen percent. Audio-visual support would consist of providing audio-visual equipment, equipment upkeep and technological support during the primary flight-training phase.

Leadership recognized the importance of Human Asset Specificity. By electing to not offer the instruction contract for competition, Fort Rucker chose to retain the contracted instructors rather than risk the loss of knowledgeable trainers. The audio-visual portion of the training process offered a lower threat of opportunistic behavior due to the availability of other suitable contractors if the winning contractor could not fulfill their responsibilities. Moreover, the base itself could provide audio-visual support from the other phases of flight-training. This provided the command a way in which to diminish the potential for opportunistic behavior.

When evaluating any transaction, asset specificity must be considered. By being able to recognize issues that relate to asset specificity, managers can avoid problems after the outsourcing study is completed. What constitutes a "Red Light" in this area? Whenever a potential contractor is asked to invest in specific assets, there will be a chance that the firm could exhibit opportunistic behavior. This is even more likely when

a firm is the only supplier that can meet the contractual needs, say due to the highly specific nature of the transaction. In this case, contracts would need to be well specified, with a detailed cost structure that offers incentives and award fees to reward outstanding service. Substandard performance would be delineated in the contract and would result in the loss of incentive and award fees. In contrast, a fixed price contract would open the government to a high probability of opportunistic behavior.

A “Yellow Light” would be more difficult to determine, as it involves judgments by management and the contracting officer. In this case, of a lesser degree of asset specificity, managers would need to understand the contractor’s capabilities, the availability of other firms, and the government’s ability to vertically integrate if necessary. Fort Rucker management chose not to recompete or restructure the flight instructors or maintenance contracts. Since this had been a long-standing and effective relationship, this was probably wise. A new contractor would have likely had to move substantial new employees into the Fort Rucker area, and could have resulted in the loss of quality instructors from the existing contractor. This provides is a good example of a Yellow Light. While a new contractor may have come in and performed better than the existing firm, you would that’s not known until a contract has been negotiated and signed. The existing contract with the firm performing the flight instruction clearly stated that the government had to give the contractor 60 days notice if a significant drop or increase in service was necessary. This clause helped to protect the contractor and the government. Unavoidable contingencies were negotiated on a case-by-case basis.

Where physical asset specificity is very low, such as janitorial services, this would constitute a Green Light situation. If there are plenty of other firms, and the tasks to be performed are fairly routine, the threat of opportunistic behavior is minimal. This would appear to be the case in the audio-visual contract at Fort Rucker’s primary flight training program. Moreover, the government has the ability to reassume the function if the contractor performs inadequately. In this case a simple fixed price contract is probably sufficient.

## **B. COMPLEXITY**

In general, the more complex a transaction, the more difficult it is to realize cost savings through outsourcing. Extremely intricate and complex transactions are good candidates for vertical integration.<sup>1</sup> However, DOD does not possess the capability to retain all functions internally. Even the most complex transactions need to be outsourced in order to capitalize on market forces and commercial firms competitive advantage (or core competencies).

A good example of this is the Navy/Marine Corps Intranet (NMCI) project. NMCI is to provide the development and implementation of the capital infrastructure necessary for the transmission of voice, video and data for the Department of the Navy. This includes maintenance, training and operation of the system, as well as service requirements specified in the NMCI contract. NMCI is to provide a universal Information Technology (IT) system that supports the Navy's core business, scientific, computational requirements and warfighting capabilities. NMCI geographic service areas are all of the Continental United States as well as the Navy's numerous overseas installations. It will serve an estimated 360,000 Sailors, Marines and civilian personnel.

The contract was awarded with a base period of five years, with an option for an additional three years at the government's discretion. (NMCI Contract: p. 2). The contract is structured like a cost reimbursement contract with numerous incentive and award fees. The contract was awarded to Electronic Data Systems (EDS) who is the lead contractor (NMCI Contract: p. 78).

This is an extremely complex transaction undertaken by both the government and EDS. The contract governing this transaction is over 100 pages long and contains numerous stipulations for performance and payments. In attempting to solve asset specificity issues, the contract specifically addresses Government Furnished Equipment

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<sup>1</sup> In the case of a very complex transaction that is being outsourced, the ability of the contracting officer to write a "complete contract" that minimizes opportunistic behavior that could occur from a variety of situations is extremely difficult. If the firm (potential buyer) has some ability to perform the function internally, this may be a better choice rather than to enter into an arrangement with another firm that could issue a "holdup".

(GFE) requirements as well as contractor provided material. The contract also has language that addresses the need for flexibility on both the part of the government and contractor.

This contract and project is extremely complex. The size of the project alone makes this a difficult undertaking. Coupled with the installation and training of Navy and Marine Corps personnel on more than one continent, there could be conflict and opportunistic behavior on the part of both parties.<sup>1</sup> Due to the vast nature of this undertaking, the Navy had no choice but to choose to outsource this function as it did not have the expertise to implement NMCI internally. Additionally, the size of the project greatly limits the number of commercial firms with the expertise and capital required to bid on such a contract.

NMCI would be a good example of a Red Light scenario. Due to the size of the task and the lack of internal capabilities, vertical integration was not considered. The contract that is currently in place attempts to address numerous areas of concern, but likely will have some shortcomings that will be manifested as NMCI is implemented and maintained.<sup>2</sup> Here, and in other red light situations, a contract must have the proper incentives and governance mechanisms in place to protect both parties. When a red light transaction is identified, defense managers should consider vertical integration as an option. Furthermore, when constructing complex contracts, due consideration must be paid to the length of the contract in order not to afford too much leverage to the contractor.

Defining Red, Yellow or Green Light transactions will be determined by the managers and contracting officers asking the following questions: How many firms can perform this function? What is the composition and degree of asset specificity involved? What are the opportunities for holdup? What is a reasonable contract period that will

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<sup>1</sup> There is considerable chance that both parties could use opportunistic behavior. For instance, the contractor could take every clause in the contract literally and perform only the minimum required actions. Additionally, support contractors throughout the service area, especially in overseas locations, could attempt to exploit position as technical experts over governmental customers. In contrast, the government could attempt to use “gray area” in the contract to get additional support or goods and services from the contractor.

<sup>2</sup> There is the concern asset specificity could lead to under-investment by the contractor in assets and inputs which could lead to higher costs. Again, the ability to write a “complete contract” is difficult in extremely complex transactions.

allow the government the ability to renegotiate or recompete if necessary? What incentives and award fees are necessary to ensure contractor compliance that could also be used to reward outstanding performance? This will require knowledgeable managers and savvy contracting officers. Yellow Light situations present some risk, but will generally reveal the potential for cost savings and improved efficiency of undergoing an A-76 study.

Green Light transactions are easier to define. The function does not represent a complex item and can be performed by numerous commercial entities. The product or service, if unable to be adequately performed by the contractor will not lead to unsafe conditions or immediately affect mission capabilities. Contracts like the procurement and maintenance of office machines, such as photocopiers is a good example. There are numerous companies that can provide the machines, with numerous support contractors that can be used to perform routine or urgent maintenance.

### **C. FREQUENCY**

Frequency, coupled with asset specificity and complexity shape how outsourcing should be evaluated and implemented. Transactions that occur on a frequent basis can have high start-up costs associated with specialized assets and may require greater governance mechanisms. However, recurring transactions also afford the possibility of cost savings associated with learning curve theory, and reputation effects which can benefit both parties in the long run (Melese & Franck: p. 16).

Maintenance actions, especially at the depot level, provide a particularly good example of frequency concerns in the TCE framework. Depot maintenance is performed away from the command or organizational level, and can be performed by a commercial or military facility. The type of maintenance can range from repair of small, intricate electronic components to entire aircraft engines. Depot level maintenance is intended to take advantage of specialization to evaluate, repair or dispose of high cost repairable items. The depot maintenance concept allows unit repair personnel to perform routine

repairs. More complicated actions, such as emergent repairs to an aircraft engine are referred to depots for detailed troubleshooting and assessment.

Depot maintenance facilities often have test equipment that is specific to the items to be evaluated and repaired. Due to the specialized nature of much of the work, contractors are necessary to provide expertise and equipment. Depot maintenance ground rules have changed in favor of the commercial sector. The 1998 Defense Appropriations Act established the “60/40 Rule” which increased the portion of depot maintenance that could be performed to 60 percent from 50 percent. Additionally, the 1998 bill made great revisions to the way in which commercial maintenance facilities account for costs (Ford: pp. 15-19).

While there is considerable depot level asset specificity, frequency issues are also important. Commercial facilities and military depots must be able to perform maintenance quickly and effectively to ensure that repairable items are returned to the supply system as quickly as possible or are replaced with newly procured units.<sup>1</sup> Only depots that can demonstrate sufficient capacity should be used. In many instances, DOD does not have the expertise or facilities to perform certain types of depot level maintenance, which dictates commercial sources be considered.

Red Light assessments are functions that must be performed quickly on a frequent basis. Depot maintenance is a good example. The ability to perform complex maintenance actions effectively on a recurring basis is critical. If a commercial depot cannot perform these actions in a timely manner, a negative impact on mission readiness could quickly ensue. When transactions of this sort put the government at risk, vertical integration should be considered (if DOD has facilities or personnel to perform the tasks internally). Additionally, costs associated with governance and contract administration would likely be significant, thereby reducing possible savings. In this situation, the government would choose a cost type contract that would provide incentives for outstanding performance, along with clear guidelines for minimum acceptable performance.

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<sup>1</sup> “Frequency” seems something of a misnomer. Time sensitivity of the service is an important consideration in relationships like this, which may indicate more of a temporal asset specificity problem (or bottleneck activities).

Yellow and Green light areas would involve transactions that had reduced frequency, and less specialized assets. The less reliant a buyer is on the firm to quickly provide a service, the lower the risk of opportunistic behavior.

#### **D. INTEGRATION**

Defense managers and contracting officers need to understand how asset specificity, complexity and frequency can impact a transaction. The more Red Lights that are present, the more defense managers must be involved in the contracting portion of the A-76 process. Sometimes, Red Lights will provide an indicator that vertical integration may be the best option.

When evaluating transactions with predominately yellow lights, the importance of contracting becomes paramount. These types of situations should drive contracting officers and management towards cost reimbursable contracts with incentive and award fees. Contracts should have a good blend between rewarding outstanding performance and penalizing inadequate service. Both sides should carefully consider how to account for changes in requirements and workload. The example of Fort Rucker primary flight-training contract showed that deviations from expected workload should be conveyed to the contractor early so that the government does not incur unnecessary costs and the contractor is not forced to operate at less than optimum efficiency.

Green light transactions are easier to evaluate and contract. These transactions may be so common that a contract that extends beyond a single event would be counter-productive. In these cases, the opportunity for the government to save money and increase efficiency exists by virtue of the power of the marketplace.

Regardless of the how many Red, Yellow or Green Lights are present when evaluating an outsourcing candidate, it is important that the leadership and customers that will be affected by the ultimate decision be actively engaged in the process early on. When there is a mixture of Red, Yellow and Green lights, managers and contracting officers familiar with that particular A-76 study must make subjective judgments based on the best information they have available.

The factors of asset specificity, complexity and frequency offer a unique perspective for defense managers. Too often, DOD personnel become engulfed in the process of the A-76 study, such that potential danger signals are missed. If characteristics of transactions such as asset specificity, complexity and frequency can be integrated into the A-76 process, along with current DOD outsourcing regulations, then defense managers would have a powerful device to improve defense decisions.

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## **V. CONCLUSIONS**

Within the economic world, the concepts of Transaction Cost Economics (TCE) are becoming widely accepted. The Department of Defense, under the mandate of Office of Management and Budget (OMB) Circular A-76, has moved forward with an aggressive push towards outsourcing as a way to save money. The concepts of TCE could greatly enhance the A-76 process and lead to better decision making.

### **A. RECOMMENDATIONS**

There could be great benefit to the Department of Defense if acquisition personnel and defense managers had a better understanding of TCE. The risk of opportunistic behavior and concepts of asset specificity, complexity and frequency apply to virtually all A-76 studies. Many managers already implicitly consider these factors. Specific actions and training in TCE could assist DOD personnel in the A-76 process and help attain cost savings that outsourcing is designed to achieve.

#### **1. Evaluate A-76 Studies and Outsourcing Actions Using the TCE Factors of Asset Specificity, Complexity and Frequency**

As demonstrated in Chapter IV, a simple evaluation methodology using the concepts of asset specificity, complexity and frequency could provide DOD personnel with a powerful tool to evaluate outsourcing actions. By using TCE, defense managers would be more likely to focus on carefully defining and understanding the characteristics of the function undergoing the A-76 study, before getting entangled in the bureaucratic web of A-76 and outsourcing regulations. Furthermore, the Red, Yellow and Green Light system could assist DOD managers by offering a simple model to assess transactions.

#### **2. Provide Training on Transaction Cost Economics to A-76 Participants**

Providing TCE training to acquisition personnel would provide a better understanding of the economic forces that are at work in the outsourcing process. This

training would not be a replacement for training in current DOD and service-specific acquisition guidelines, but rather would complement that training.

The participants in the A-76 process do not always share the same goals. First, there is the customer who wants to get the A-76 process to provide the highest level of service at the lowest costs. The customer is not very concerned with contracting procedures or regulations so long as they do not hinder the study. Next is the financial managers, or comptrollers. Their primary concern is the bottom line. Comptrollers want A-76 competitions that reflect real cost savings with little chance of a lengthy (and possibly expensive) appeals. Finally, there is the contracting officer. The contracting officer seeks to write a contract that adequately describes the function to be outsourced while protecting the interests of the government. Contracting officers are often more concerned with adhering to the myriad of contracting regulations than they are in achieving cost savings. By integrating the principles of TCE in the outsourcing process, all participants would have a uniform criteria in which to evaluate the A-76 function under study.

Not only should acquisition personnel, such as comptrollers and contracting officers receive TCE training, but so could personnel that are in leadership positions and that will undergo or are likely to undergo an A-76 study. Defense managers that are part of an organization undergoing an outsourcing study are critically important in assisting the contracting officer in the outsourcing process. While contracting officers make every attempt to understand the function that is being contracted out, only personnel that are in the agency can fully understand how the concepts of TCE will affect the ultimate outsourcing decision. Finally, providing TCE training would require the development of new applied materials and case studies since much of the current literature is focused on business rather than government outsourcing.

### **3. Provide a DOD A-76/Outsourcing Case Study Database**

Currently, the only thing close to a DOD outsourcing or A-76 database is the Commercial Activates Management Information System (CAMIS). CAMIS is geared primarily toward contracting officers and is not readily available to all DOD personnel.

It consists of past performance data by contractor, baseline cost data at contract award date, and deviations from the baseline cost data for three years after the contract award. Each service maintains their own version of CAMIS. The case studies are anecdotal, at best. Usually, only case studies that go terribly wrong or are overwhelming successes are available in the literature. Most of these case studies have been written up well after the fact by outside agencies such the Center for Naval Analysis or RAND.

DOD would be well served to build and maintain a lessons learned or case study database that uses less contracting jargon and is written more in laymen's terms. In this new system, completed A-76 studies could be sorted by the type of function that was studied, by service, or by whether the study was won by a commercial contractor or the Most Efficient Organization. Additionally, a search function would greatly assist defense managers in finding and studying previous A-76 competitions.

This system would be beneficial in several ways. First, it could assist defense managers with little experience in A-76 that are about to go through the outsourcing process. Second, it would be helpful for managers that take over after an A-76 study has been completed, to evaluate if the intended savings and benefits were realized. Finally, it could provide contracting officers a source of data that would assist them in understanding the type and characteristics of the function under study.

## **B. AREAS FOR FURTHER RESEARCH**

There is a rich literature available on TCE, mostly written from the academic standpoint or studying business outsourcing actions. With the exception of Melese and Franck (2002), little research appears to be available applying TCE to the defense arena. If DOD is to achieve the cost savings that so many believe that outsourcing can deliver, then the effects that TCE has on the process should be considered in greater detail.

**1. Study a Single or a Group of Similar A-76 Competitions Using TCE**

By evaluating a similar type or “bundle” of transactions using TCE, this research could help anticipate common problems in future outsourcing studies. This could expose recurring problems that exist in similar A-76 studies that have been completed.

**2. Evaluate the Feasibility of Establishing a DOD or Service Specific Outsourcing Database**

A lessons learned, or feedback mechanism could assist future DOD managers in making outsourcing decisions. Additionally, identifying A-76 competitions that did not yield anticipated savings could provide insights for future A-76 competitions.

**C. CONCLUSION**

The Department of Defense could improve the A-76 process by integrating the concepts of Transaction Cost Economics in outsourcing decisions. The current A-76 process has eleven distinct steps that are driven by government bureaucracy that often overshadow the intent of the OMB Circular A-76. By investigating the basic characteristics of transactions, such as asset specificity, complexity and frequency, DOD and the services stand a better chance of achieving meaningful cost savings.

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